

# FINANCING DEVELOPMENT IN THE UNECE EMERGING MARKETS

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Developing and emerging market economies need more resources than are usually accessible domestically in order to fully exploit the investment opportunities available to them while also addressing the basic needs of their populations. Although it is often possible to reallocate some additional domestic resources towards these developmental objectives, there are limits, and a more viable option exists based upon obtaining them from abroad. These external resources can be obtained by earning them primarily through exports, being given more in terms of aid or borrowing more from global capital markets. This is the basic economic logic behind the global initiative to increase the resources available to developing countries that was formalized in Monterrey, Mexico in 2002. Prior to this, the world community had agreed in 2000 on an ambitious programme, referred to as the United Nations Millennium Project, to cut global poverty in half by 2015; however it was immediately recognized that this goal could not be achieved unless the developing and emerging market economies (henceforth, simply emerging economies) were provided far more in terms of external resources. There were, in fact, estimates made as to how many additional resources would be required in order to meet the Millennium Development Goals (MDG) and the amount that could reasonably be raised domestically; the difference between these two was termed the MDG financing gap. For the poorest countries this gap was estimated to be over 20 per cent of GDP; in five of UNECE's lowest income countries (Armenia, Kyrgyzstan, Moldova, Tajikistan, and Uzbekistan) it was estimated to be approximately 10 to 20 per cent of GDP.

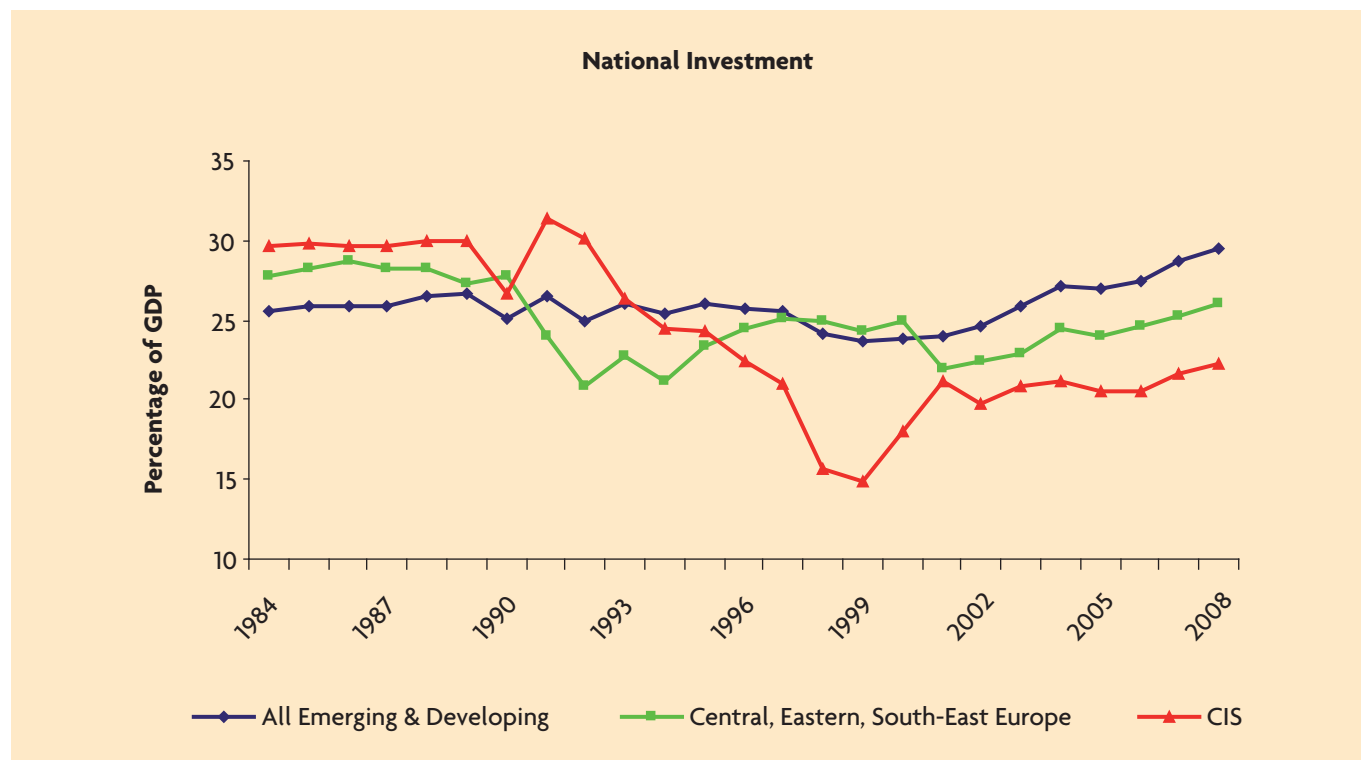
Thus in Monterrey, the United Nations Member States convened the International Conference on Financing for Development (FfD) and agreed on a set of actions to address this resource shortfall so that the developing world could eradicate poverty, educate its children, and provide basic health care while achieving sustainable economic growth within a fully inclusive and equitable global economic system. More specifically, the agreed-upon actions can be grouped into the following six categories: (1) mobilizing more domestic resources, (2) encouraging foreign direct investment (FDI) and other international capital inflows, (3) promoting international trade and market access, (4) increasing international financial and technical assistance, (5) reducing external debt whose interest payments are consuming too many resources, and (6) enhancing the coherence and consistency of the international monetary, financial, and trading system, all with a view to fostering economic and social development. This set of actions must be viewed as part of a global partnership with the ability of each country to fulfil its responsibilities being contingent on others fulfilling theirs.

Although some progress has been achieved in advancing the objectives set out in Monterrey, in some areas progress has been disappointing. In November 2008 there will be a follow-up United Nations conference in Doha, Qatar to assess what has and has not been achieved and what is required to ensure that the developing countries have the resources they need in order to ultimately achieve the MDGs by 2015. The meeting will discuss best practices, identify constraints, reaffirm goals and based upon the discussions and negotiations could give rise to some new global mandates. This paper attempts to provide an overview of the FfD project with an emphasis on its status in the UNECE emerging markets. It is noteworthy that the experiences of the UNECE economies are significantly different in several important respects from those in much of the rest of the world. There are potentially important lessons for the world's emerging economies in understanding these differences and why they have occurred.

The primary reason living standards are higher in the advanced economies is that their workers are better educated and have more machinery and infrastructure with which to work. Therefore to increase national income in the emerging economies, more must be invested in physical and human capital. As shown in figure 1, investment rates in the emerging economies have increased marginally over the last five years after being relatively stable for much of the 1980s and 1990s. Although the investment rates for the UNECE emerging markets have also picked up recently in both of its subregions – Central, East and South-East Europe (CES Europe) and the Commonwealth of Independent States (CIS) – they remain below the developing world average and below their own levels prior to the transition<sup>1</sup>. However the high average investment rate in the emerging countries is due to very high rates (around 35 per cent) in the developing economies in Asia; CES Europe has rates similar to or even above most of the other regions of the developing world while investment in the CIS has been especially low.

<sup>1</sup> The data values for CES Europe used in this paper often do not include several of the former states of Yugoslavia because of data limitations; nevertheless the general points made in this paper regarding the CES region apply to these economies as well. The regional grouping Commonwealth of Independent States (CIS) is used to refer to the 12 former members of the Soviet Union (excluding the three Baltic States) and does not explicitly refer to the institutional arrangement of that name; some CIS aggregates do not include data for Turkmenistan or Uzbekistan due to data limitations.

Figure 1. Investment rates in UNECE emerging economies



## MOBILIZING DOMESTIC RESOURCES

For most countries, the majority of investment comes from domestic savings; thus if there is a perceived need for more development finance, the first step would appear to be to increase domestic savings and to ensure that this supply of funds finds its way into useful investment projects. However, increasing savings means reducing consumption; if there is significant existing poverty and the objective is to maximize social welfare over time, it is not clear that this is best achieved by further reducing the poor's current living standards so that future generations, which are likely to be much richer anyway, might be even richer. Thus although increasing economic growth is desirable, it is not necessarily optimal if it comes at the cost of significantly reducing current living standards; thus it is not clear that public policy should be directed towards increasing savings. This same basic trade-off exists not just for societies in the abstract but for individuals in the society; we could all be richer tomorrow by saving more today, but most choose to give considerable weight to consuming today. In fact, many consumers in fast-growing developing economies may not only not save, but may wish to borrow now against their expected future income. This desire to smooth one's consumption over time is one of the most basic principles of economics; this is referred to as the permanent income hypothesis and was one of the major contributions of Milton Friedman which won him the Nobel Prize in 1976. Obviously overall saving within a society is the sum of what different age cohorts chose to do, with the young wishing to borrow, the elderly dis-saving by living off previously acquired wealth, and the middle-aged saving for retirement. In addition, the poor in low-income economies often do not even have the option of saving as they need their entire income just to survive; this explains, for example, the relatively low savings rates in much of sub-Saharan Africa. Thus the predicament for these emerging economies is that the demand for funds in order to finance development is very high but it is not clear where those funds should come from.

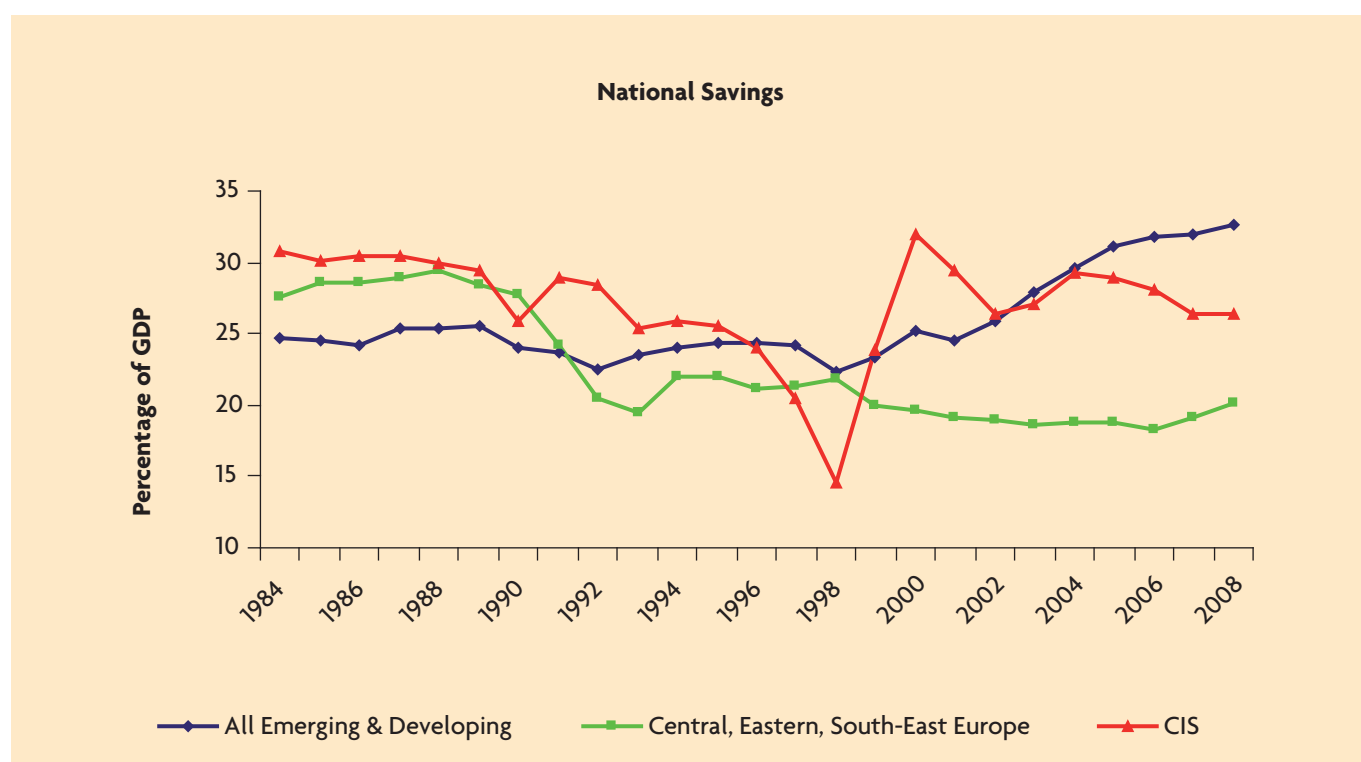
Low domestic savings has particularly characterized the UNECE emerging markets since the beginning of the transition process. In Figure 2 the overall savings rates for these economies are compared to those for all of the emerging economies. Before the transition to market economies, the UNECE emerging markets had higher savings rates than the other emerging economies; these savings rates then fell during the 1990s. After 2000, savings in the rest of the world began to increase substantially (due partially to improved economic growth) while they only marginally improved in the CIS and actually fell further in CES Europe. The savings rate in this latter region is now only 60 per cent of the average rate of all emerging economies. Thus in terms of the FfD objective of mobilizing domestic resources, to the degree that it is dependent on increasing savings, the developing world has made some progress since 2002 although many of the UNECE emerging markets

have not. This is somewhat paradoxical in that CES Europe is one of the richer emerging regions and thus could potentially better afford to postpone consumption by saving more.

There are several factors that have contributed to the low savings of the UNECE emerging markets. Incomes fell significantly during the early transition years, perhaps by a fifth in central Europe, a third in South-East Europe and up to half in some of the CIS. Therefore consumers have been smoothing their consumption not only in anticipation of future income growth but also in order to maintain living standards during this drop in income. Also during periods of uncertainty, conflict and rapid inflation, individuals are likely to put more emphasis on the short-run by consuming and this certainly characterized much of the region during the 1990s. Although economic factors are likely to provide most of the reasons for the UNECE region's low savings, cultural factors especially in regard to Asia's high savings rates may also be important. In market economies, a significant proportion of savings comes from business profits, and these have not been particularly high as it has taken time to establish profitable private firms. In comparison, an important component of China's high national savings is its high business savings which results from high business profits due to low wages, a competitive exchange rate, and minimal dividend payments since shareholder rights are limited and state enterprises do not pay dividends to anyone (even the government). Chinese personal savings are also high given limited retirement benefits and health insurance.


Another domestic source of funds for financing development, especially of public infrastructure and other public goods, is from government resources obtained from taxation or borrowing. Increasing taxes, however, is subject to the same qualification as increasing savings in that it comes at the expense of current consumption. The alternative, government borrowing, however,

Figure 2. Comparison of overall savings rates of UNECE emerging economies and all emerging economies



uses up private savings and thus crowds out private investment. Although there is some evidence that a fiscal deficit is partially offset (generally estimated by half) by increases in private sector savings (referred to technically as Ricardian equivalence)<sup>2</sup> it is still believed that public borrowing lowers national savings and this relationship is found to be stronger in emerging markets. Although there are a few exceptions, government deficits throughout the region are not particularly large; nevertheless they are too large to be prudent given the overall macroeconomic situation and the fact that private savings are so low.

<sup>2</sup> The logic being that people realize that a tax cut today implies a tax increase in the future, thus they start to save more now so they will be able to pay their future taxes. Although this sounds a bit far-fetched, the empirical evidence tends to at least partially support it. If this equivalence does hold, then there is no difference between financing government through taxes or borrowing.



Thus the degree to which economic policy should attempt to increase domestic savings is somewhat unclear; what is clearer, however, is that the available savings should be used efficiently. Translating domestic savings into productive investment is referred to as financial intermediation, and the degree and efficiency with which this is achieved is dependent on having well-developed banking and financial markets which are supervised within the proper regulatory framework. Fundamental to creating an effective financial system is the ability of the banks to attract deposits from consumers. Historically savers in many emerging economies, including some in the UNECE region, have been distrustful of the banking system; this is especially the case in those economies that have experienced financial crises where the population suffered significant losses on their deposits after banking failures. In these countries, individuals often choose instead to deposit their funds abroad (external capital flight) or if that option is not available, they may simply hide them in their mattresses (internal capital flight); in either case the funds essentially disappear from the economy. Thus although the population saves, the savings are not converted into domestic investment. Currently in South-East Europe and the Russian Federation only a third of households have a bank account while less than a tenth have one in the other CIS. There are a number of policies, such as introducing bank deposit insurance, that can help increase confidence in the banking system.

Inefficient financial intermediation has been a problem for many of the UNECE emerging markets as their financial systems came out of the transition underdeveloped compared to other economies with similar per capita incomes; however, this is an area in which significant progress has recently been made. Central to this effort has been the extensive privatization of the banking sector especially in CES Europe, which in many cases also includes foreign (mostly EU) ownership or participation. Although the privatization process has proven to be important in improving intermediation, technically this step is neither necessary nor sufficient. Many of the UNECE economies have now progressed from a state of having repressed financial conditions characterized by small banking sectors and low consumer debt to one more consistent with a “normal” market economy. However, financial intermediation remains low in a number of the poorest CIS economies such as Turkmenistan and Uzbekistan, and thus they have the most to gain from further improvement. For example, in 2005, bank lending accounted for only 3 per cent of fixed capital investment in Moldova; the majority was self-financed (69 per cent) with state and local governments financing most of the remainder. Stock markets provide another avenue for channelling savings into productive investment; the capitalization of domestic stock markets of the EU new member states have been increasing quite rapidly over the last several years, while these markets are still immature or non-existent in much of South-East Europe and the CIS.

As a result of this restructuring of their financial systems, bank loans, especially to households often for mortgages, have been growing extremely fast and have doubled in a number of countries over the last several years. In Kazakhstan, for example, domestic credit in August 2007 was 7.5 times what it had been at the beginning of 2004. Although rapid credit growth is a normal process and characteristic of financial deepening in emerging markets, it has recently been much faster in the UNECE region than elsewhere and may now represent a significant vulnerability for the region. The problem is that much of the financial-institutional and regulatory infrastructure in these economies is relatively new and untested. This includes such things as credit rating agencies, ownership registers, appropriate legal instruments for repossessing collateral, instruments for securitization of risks, and management practices for assessing risks. Nevertheless this rapid increase in private sector lending is a positive sign that concerns about property rights and contract enforcement, which had been problematic, have now improved to a sufficient degree so that banks have confidence in making these loans. A mitigating factor is that the fastest growth in credit has generally occurred in those economies where the outstanding “stock” of credit is the lowest as a percentage of GDP. In addition to rapid credit growth, an additional vulnerability concerns the fact that loans in a number of these economies continue to be denominated in foreign currencies; this could present problems if their currencies were to depreciate significantly.

This expansion of banking credit has increased funding for small enterprises and women entrepreneurs, and this has been especially useful given that it promotes employment of unskilled workers prone to poverty. In addition, this credit expansion has been used to finance house mortgages when previously only those with existing resources were able to purchase homes. Increasing access to bank credit, however, results in not just additional investment but additional consumption as households borrow to improve living standards. In fact financial development often increases household consumption-borrowing more than investment; thus improved intermediation is only marginally effective in obtaining more development finance from the domestic market.

## EXTERNAL FINANCE

As explained above, although there are a number of things that can be done to increase the amount of domestic resources available for addressing developmental objectives, they are often of limited effectiveness or involve serious trade-offs that a society may not wish to make. An alternative option is to obtain these additional resources from abroad. The difference between

the UNECE region's low rates of domestic savings and their higher rates of domestic investment is due largely to their dependence on external resources. In fact, it is in this area that the experience of UNECE emerging markets has been quite different from most other developing countries. Within the region there has been a significant distinction between CES Europe that has relied on external resources and the CIS that has not. Within the CIS, however, the non-energy exporters (Armenia, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan and Ukraine) have also received sizable external resources and have a pattern somewhat similar to CES Europe, while the Russian Federation and the other energy exporters have actually provided resources to the rest of the world.

In analysing the use of external resources a key concept to understand is what is referred to as the net resource flows to an economy. It represents the difference between what a country produces and what it absorbs, the latter being the sum of what a country (private and public) consumes and invests. It also is equivalent to the trade balance on merchandise and services; it thus represents what a country either gets or gives to the rest of the world in terms of real goods and services. One of the central objectives of the FfD initiative has been to increase net resource flows into the emerging countries, in order to allow them to absorb more resources than they produce, the idea being that these additional resources would be used to increase either investment for development or consumption for poverty alleviation. However, the emerging economies as a group, instead of actually receiving real net resource inflows (i.e., goods and services) have actually provided net resources to the advanced economies, averaging 3.2 per cent of their GDPs over the 2001-2007 period. This transfer has been increasing and reached 5.1 per cent of their GDP in 2006. Thus they have only absorbed about 96.8 per cent of what they have produced over the last seven years. This, of course, is the opposite of the objective implicit in the FfD Consensus. This is true not just for the developing countries as a group but for all the major regions of the world – Africa, developing Asia, the Middle East, Latin America and the Caribbean, and the CIS (due to the weight of the energy exporters).

The one major exception to this pattern has been CES Europe which received net resource inflows that averaged over 4.4 per cent of their GDPs during 2001-2007; thus these economies have been able to absorb 104.4 per cent of what they have produced. This resource transfer into CES Europe has been on an increasing trend, as it was 5.3 per cent of GDP in 2006, and is expected to be 5.9 per cent of GDP in 2007 and 6.3 per cent of GDP in 2008. This result is not due to a few large countries dominating the CES average but is a characteristic of almost all of the countries of this region. However, reliance on external resources is much greater in South-East Europe and the Baltic economies than in Central Europe. In addition, this is not just a recent phenomenon; during the previous seven years (1993-2000) CES Europe had net resource inflows of 3.9 per cent of their GDP, while all other emerging countries had inflows of only 0.1 per cent of GDP and none of the other regions had net inflows of even one half of those of this region. When you combine the fact that CES Europe absorbs more than it produces with the fact that the rest of the emerging world does the opposite, the result is that CES Europe has been able yearly to absorb resources valued at about 8 per cent of GDP above what it would have if it had followed a similar pattern as other emerging economies; this increased to almost 11 per cent of GDP by 2006. Thus over the last 14 years these extra resources have allowed the region to build public infrastructure, build plant and equipment, and consume at levels above what other countries have been able to do, after controlling for national income. This significant resource transfer to CES Europe and to a lesser degree the CIS non-energy exporters has undoubtedly been a major factor in the economic development of these regions.

## CAPITAL FLOWS

So far the analysis has focused on the real dimension of resource flows, i.e., the real goods and services that have been transferred across borders which are equal to a country's trade surplus. There is, however, a mirror image financial transfer, that being the exchange of paper instruments (or in today's world, electronic entries) associated with this real transfer. In this dimension, net resource flows are essentially equal to its financial inflows minus its financial outflows. Financial inflows are composed largely of net capital flows, foreign aid, and the remittances from those working abroad. Financial outflows are composed principally of a country's payments for previously obtained capital (i.e., interest payments on debt and profit repatriations) and the purchase of international reserve assets by the central bank.

### Net Real Resource Transfers

Net Private Capital Inflows

+ Foreign Aid

+ Factor Payments from Foreign Use of Domestic Factors (i.e., Remittances)

– Factor Payments for Use of Foreign Owned Factors (i.e., Profit Repatriations)

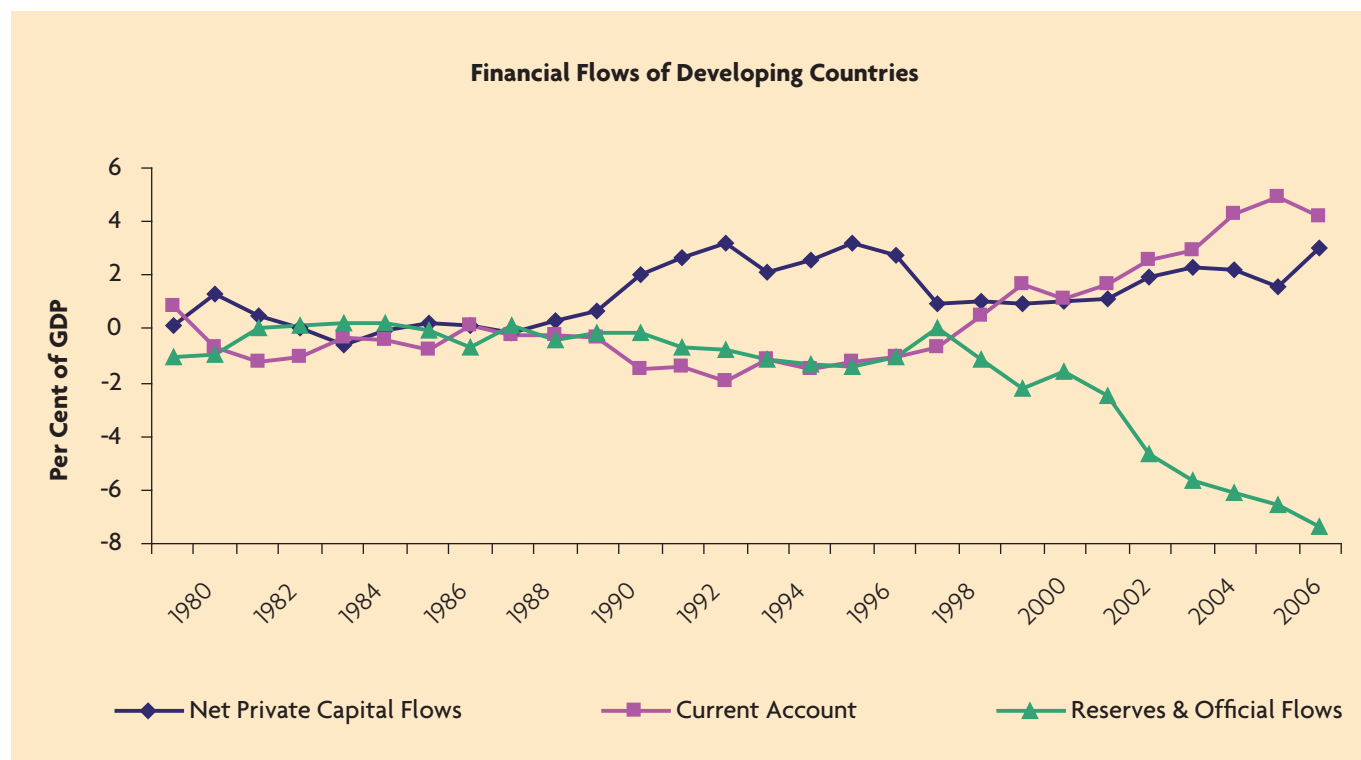
– Purchase of International Reserves and Official Capital Flows

= Net Real Resource Transfer = Merchandise and Service's Trade Balance

For emerging countries as a group, the amount they receive in aid and remittances is approximately equal to what they pay out to service their debt or compensate foreign investors; thus these two components essentially cancel each other out in terms of net resource flows. It is therefore the relationship between private capital inflows and governments' purchase of assets (reserves and debt) that determines net resource transfers. In 2006 the emerging countries had net private capital inflows of around 1.6 per cent of their GDPs while they spent 6.5 per cent of their GDPs on purchasing additional international reserves and paying back debt (official capital flows). Subtracting these two (1.6 minus 6.5) and adjusting slightly for aid, remittances and factor payments (-0.3) equals net real resource flows of minus 5.1 per cent of GDP. Thus essentially for every dollar they received in net private capital inflows they purchased over four dollars of international reserve assets (-5.4) or repurchased their own existing debt (-1.1). The extra three dollars were obtained by exporting more real goods and services (5.1) than they imported.

The current situation differs from the historical pattern in that in earlier periods including the 1990s, at least some of the private capital inflows were used to import real goods and services. In figure 3 these three important financial flows are plotted from 1980 to 2007; positive numbers represent a source of funds and negative numbers represent a use of funds.<sup>3</sup> There has generally been an inflow of private capital to the emerging countries except for a minor outflow in the mid-1980s; inflows peaked in the mid-1990s, fell with the currency crises and stock market collapses at the end of the decade and have gradually recovered. However, it is how these funds have been used that is different. In the 1990s, approximately one-half of the private capital inflows were used to import real goods and services (in excess of what they produced) so there was a real net resource inflow. The other half of net private capital inflows essentially went to purchase additional international reserves or pay off official external debt. The situation today, however, is that not only are the emerging economies using all their net capital inflows to purchase additional reserve assets, they are also transferring real goods and services to the advanced economies (by exporting more than they are importing) in order to obtain additional foreign exchange to purchase even more reserve assets.

Figure 3. Financial flows of development countries, 1980-2007



<sup>3</sup> The current account is used in this graph to proxy net resource transfers (i.e., the trade balance on goods and services) because of data availability; factor payments and transfers are relatively small and generally cancel each other out.



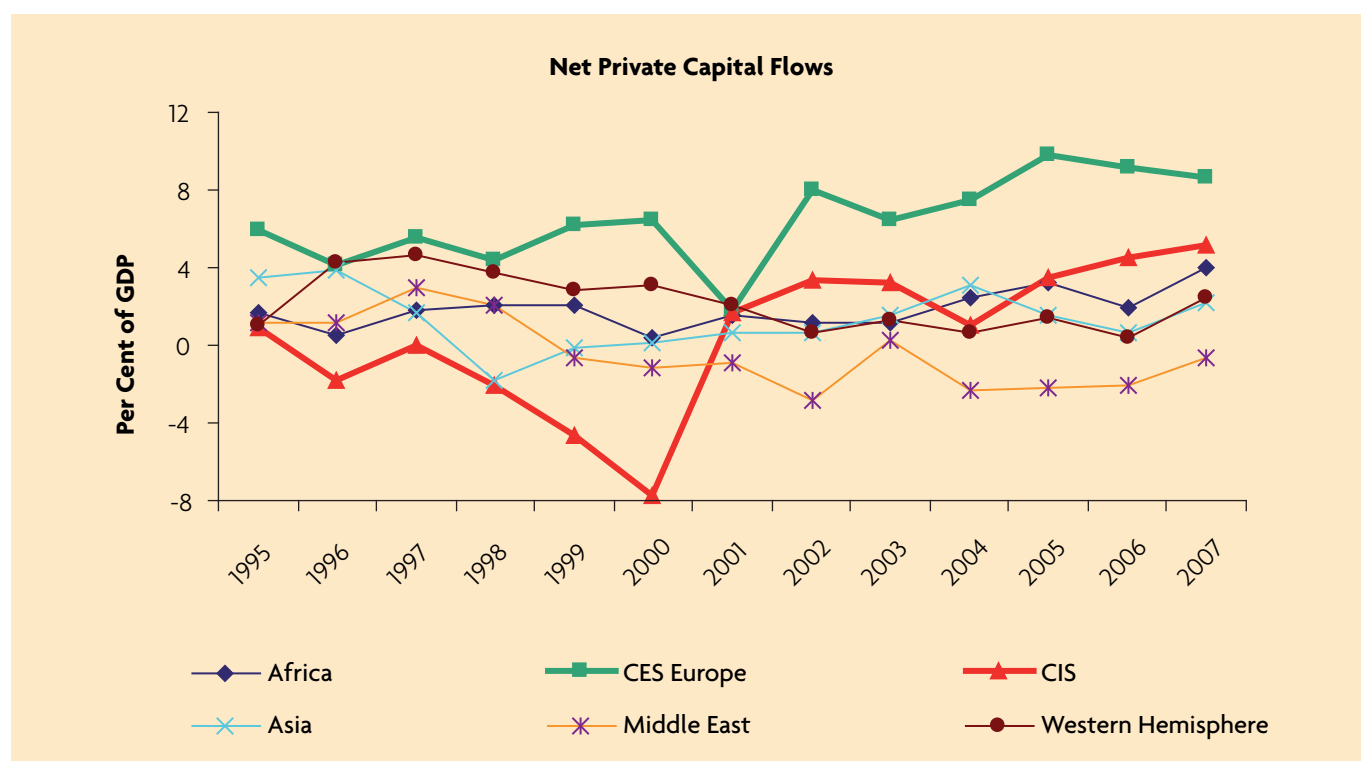
There are a number of possible reasons why these economies have purchased so many international reserves. Generally, it is the result of either an explicit policy choice to acquire more reserves to promote financial stability and avoid the possibility of having to borrow from the International Monetary Fund, or it is a by-product of an export promotion growth strategy that is dependent on having an undervalued exchange rate.

The experience of CES Europe has been substantially different in two important respects from that outlined above for all emerging economies. Firstly, net private capital inflows have been much larger in this region, and secondly, they have been used to purchase real goods and services instead of purchasing international reserve assets. Figure 4 provides net private capital flows to the major regions of the world as a per cent of their GDPs. Private capital inflows to CES Europe and the CIS have been on an increasing trend (while the other regions have been more stable) and are now significantly larger than to the other regions. Relative to GDP over the 2001-2007 period, they have been approximately five times larger in CES Europe than Latin America and the Caribbean as well as developing Asia, four times Africa, and twice the CIS. The Middle East has experienced private capital outflows over this period. Net private capital flows are the difference between inflows and outflows, and to a small degree one difference between CES Europe and the other regions is that the latter have more capital outflows; however gross inflows are bigger in CES Europe and current levels are unprecedented for emerging markets in recent history. As previously discussed, CES Europe has been using these financial inflows for importing real resources (by running trade deficits) instead of for purchasing reserve assets. It should be noted that the southern EU members – Greece, Portugal and Spain – are also following this same basic pattern of relying on external finance.

The fact that capital flows into CES Europe have been extremely large while savings have been quite low raises an obvious question as to whether one has caused the other. Unfortunately this is a difficult question to answer, as these variables are determined simultaneously with causality running in both directions. The lack of domestic savings in an environment of growth encourages capital inflows, while at the same time the capital inflows have been used by consumers for consumption purposes, and this lowers the savings rate.

The emphasis so far has been on the net flow of funds, that being inflows minus outflows because that represents the real transfer of resources. However, there may be certain characteristics of a given flow that provide benefits in addition to the real resource transfer so that even though the net flow is zero, the gain from a two-way flow is still positive. This is best explained by a few examples. The banks in Kazakhstan, as in many other UNECE emerging markets, have recently been borrowing significant

Figure 4. New private capital flows to major regions of the world as percentage of their GDP



amounts from international capital markets in order to obtain funds which they can then lend to their domestic customers. This represents a private capital inflow. At the same time the Government has been using its acquired foreign exchange to purchase significant international reserve assets. As a result the overall net flow has been relatively small; in theory the banks could have borrowed from the Government and most external flows could have been eliminated. Under either option there is no real transfer of resources into Kazakhstan in terms of access to additional real goods. Nevertheless a two-way flow (that cancels out) may be preferable to the case with no external flows in that it allows agents to diversify their activities, imposes better financial controls and promotes better efficiency. For example, reliance on foreign capital markets may force Kazakhstan's banks to perform better than they would if they were able to obtain the funds from the Government. Foreign direct investment is another case in which the capital inflow provides more than just the spending power of the capital: it is accompanied by efficiency-promoting management and technical know-how. Thus an FDI inflow matched by an equal reserve accumulation is most likely better than no FDI and no reserve purchases. There is a cost however, in that the banks and firms have to pay a higher return to borrow from external sources than the government gets paid on its reserve assets. Therefore a full appreciation of the role of foreign capital in promoting development requires an analysis of not just the net inflows but of the gross flows in both directions.

For developing countries, capital inflows can be obtained by either the private or official sector; over the last decade the overall trend has been for private inflows to increase while official inflows (especially as a percentage of inflows) have declined. There can be both private and official outflows as well; however private capital outflows are relatively small except when there is capital flight or during financial crises. Thus recently most of the outflows have been official capital outflows as Governments have paid off their debts. So the last several years have been characterized largely by private capital inflows and official capital outflows. These general trends in private and official flows have been especially notable in the UNECE emerging markets. Over the last five years (2003-2007) there has been a net inflow of \$707 billion of private capital while there has been a net outflow of \$101 billion of official capital and a \$572 billion outflow to purchase international reserves. There is, however, a major difference between CES Europe and the CIS; in the former net private capital inflows have averaged 8.5 per cent of GDP while official outflows averaged 0.5 per cent and reserve accumulation averaged 2.0 per cent of GDP. In the CIS, private capital amounted to 3.8 per cent, official outflows were 1.4 per cent and reserve accumulation was 8.5 per cent of GDP.

Net capital inflows are usually broken down into three components including foreign direct investment (FDI), portfolio (equity and bond) flows, and other flows that generally take the form of debt such as bank loans. Over the last five years (2003-2007) in CES Europe, net FDI has averaged 4 per cent of GDP, portfolio 1.0 per cent and other capital 3.2 per cent. In the CIS net FDI averaged 1.2 per cent, portfolio 0.6 per cent and other capital 2.0 per cent of GDP. Thus net private capital inflows to CES Europe have been much larger and more concentrated in FDI.

Generally, FDI outflows only begin after a country has reached a certain level of development, and thus for most developing countries there is not a significant difference between their FDI inflows and their net FDI flows. The Russian Federation and Hungary in the UNECE region however do have significant FDI outflows. As a result the difference between CES Europe and the CIS in FDI inflows is smaller than for net flows; in 2006 inflows were 6.1 per cent of GDP in the former and 3.5 per cent in the latter (compared to 5.0 and 1.8 for net FDI flows in 2006). The table provides some more detailed information regarding financial flows in the UNECE region over 2004-2006; generally positive numbers represent a source of finance and negative numbers represent a use of finance. A negative real resource flow represents use of funds for the net importation of real goods and services. The values need not add to zero since all categories have not been included.

Financial Flows in the UNECE Emerging Markets (percentage of GDP, 2004-2006)

	FDI Inflows	Portfolio Inflows	Net Other Capital	Aid	Remittances	Net Investment Income	International Reserves	Net Resource Flow
CES Europe	5.0	2.7	0.5	0.7	1.7	-3.2	-2.4	-4.9
EU new member states	5.9	2.7	-0.8	0.8	1.4	-4.0	-2.2	-3.2
South-East Europe	6.2	0.3	3.7	2.8	9.9	-1.6	-5.0	-17.8
Turkey	2.9	3.3	2.4	0.1	0.2	-1.7	-2.2	-5.1
CIS	3.2	0.9	-2.9	-0.3	0.9	-2.4	-7.9	10.4
Russian Federation	2.5	0.5	-3.0	-0.7	0.4	-2.2	-8.9	12.9
CIS-11	5.5	2.0	-2.5	1.1	2.4	-3.0	-4.9	2.3

Source: Calculations by the author; aid and investment income values based on 2004-2005




## AID AND REMITTANCES

In addition to capital inflows, there are two other important financial inflows; these are aid and remittances. Aid takes several distinct forms in the region, EU assistance, official development assistance and debt relief. Overall, the UNECE emerging markets excluding the Russian Federation receive aid in various forms that amounts to about one per cent of GDP. The EU new member states (NMS) and those approaching accession receive substantial assistance from the EU under various programmes such as its four Structural Funds, its Cohesion Fund, and payments under the Common Agricultural Policy. A comprehensive analysis of each country's share of EU operating expenditures and their share of EU contributions shows that the NMS-8 (excluding Bulgaria and Romania) received a net transfer of €6.0 billion in 2006 or approximately 1.0 per cent of the GDPs. This net EU transfer, however, varied considerably from only 0.4 per cent for the Czech Republic to 2.5 per cent for Lithuania. The candidate countries also received EU assistance under several programmes; for example Bulgaria and Romania received €1.7 billion in 2006 which was about 1.4 per cent of their GDPs. Smaller amounts were provided to Croatia and Turkey under several pre-accession instruments. Over the next budget cycle of 2007-13, EU transfers are likely to increase to around 2 to 3 per cent of the NMS' GDPs; the two newest members, being the poorest, are likely to receive considerably more; EU candidates Croatia, The former Yugoslav Republic of Macedonia, and Turkey and potential candidates in the western Balkans will also receive further EU assistance. It is generally viewed that these EU transfers have been efficiently used and there are undoubtedly valuable lessons in how this aid is planned, implemented, monitored, and evaluated that could be applied more generally to increasing the absorptive capacity of development assistance supplied to the developing countries in the rest of the world. Although difficult to quantify, it should at least be noted that subsidized energy provided by the Russian Federation to many of the other CIS countries over the last decade represented a significant transfer of resources; these subsidies have now been largely eliminated. The Russian Federation has also provided significant debt forgiveness; this was especially large in 2005; this explains the negative value for aid in the table.

Foreign aid is an important component of externally obtained funds in that it can finance projects with a public goods nature or projects which have significant positive externalities and would not be financed by the private sector. Since private capital markets seem to inadequately finance human capital development for the poorer segment of the population, aid used for health and education of this segment can contribute significantly to economic development while addressing equity concerns as well. Creating a more inclusive society is further likely to contribute to development by increasing political stability. Aid is also important in stabilizing a situation after negative shocks. An important objective in the selection of projects to be financed with aid is that they should further encourage private investment flows instead of replacing them.

Most of the poorer developing countries receive official development assistance (ODA); although aid is less than one-half of one per cent of the GDPs of all emerging economies, it is over five per cent of GDP for sub-Saharan Africa and over 20 per cent for 18 of the world's poorest economies. Overall, the amounts currently being provided are insufficient for achieving the MDGs and below what was pledged at Monterrey in 2002 and at the G-8 summit in Gleneagles in 2005. In fact, actual commitments (excluding exceptional debt relief) during the 2005-2006 period fell from previous levels. Seventeen UNECE countries are recipients of ODA including all of the CIS except the Russian Federation and all of the non-EU members of South-East Europe including Turkey. Together they received \$5.7 billion or 5.4 per cent of worldwide ODA receipts in 2005; approximately 3.4 per cent went to South-East Europe and 2.0 per cent went to the CIS-11. Montenegro and Serbia received the most in South-East Europe (\$1.1 billion) while Ukraine received the largest amount in the CIS (\$410 million). Over the last several years, as a percentage of GDP, aid has amounted to about ten per cent of the GDPs of Kyrgyzstan and Tajikistan, and five to ten per cent of GDP for Albania, Armenia, Bosnia and Herzegovina, The former Yugoslav Republic of Macedonia, Georgia, Moldova, and Serbia. For most of the UNECE recipients, ODA as a percentage of GDP has been on a downward trend over the last five years.

An important component of the advanced economies' commitment to this development agenda is an increase in ODA. Most of the advanced economies are members of UNECE; UNECE members accounted for 85.9 per cent of the ODA by the OECD's Development Assistance Committee (DAC) which provides almost 90 per cent of the world's total ODA (which equalled \$107 billion in 2005). In 2005 only four countries (all UNECE members) provided more than the United Nations target of 0.7 per cent of their gross national income in aid; these were Luxembourg, Norway, the Netherlands, and Sweden. Several UNECE members provided less than the current (2005) DAC average of 0.33 per cent; these were Greece, Italy, Portugal, Spain, and the United States. The United States however is the largest provider of ODA in terms of dollar value and provides over a quarter of total ODA.



As an interesting piece of trivia, it can be pointed out that the 0.7 per cent of GDP as an aid target that was reconfirmed in Monterrey is not a new number but has been a suggested target since the 1969 Pearson Commission on International Development. This number was not randomly picked at that time but was arrived at by calculating the amount of annual resource transfer that would be necessary to double net capital formation in the developing world. It should also be noted that for those living in the advanced economies, the 0.7 per cent target amounts to slightly less than \$1 a day per person.

Currently most of the official aid is provided by the very advanced economies, but what is the role of the middle-income countries? Within most societies, it is not just the super-rich that pay taxes that go to assist the poorer members of the society; taxes are generally levied on a fairly large segment of the population. Why should the same pattern not apply to the world economy? As part of their EU membership the NMS are committed to becoming donors as their level of development increases. By increasing the number of donors not only can the level of assistance be increased (although probably only marginally) but as stakeholders with different views and experiences they may be able to improve the dialogue between donors and recipients.


Currently there is much discussion about the effectiveness of aid. The advanced economies often allege that it is wasted while the emerging economies complain about the lack of multi-year timetables of aid delivery which would increase their ability to properly plan and manage these aid flows. Similarly, an increase in the amount of aid available to the general budget would give the recipient more flexibility than project-based financing but requires the recipient to take on more responsibility for efficiently using the aid since the donor loses a degree of control over its use.

Another significant source of external funds are remittances, that being money earned abroad by temporary workers or funds sent home by long-term migrants. Remittances to the emerging countries have been increasing quite rapidly and have more than doubled over the last decade and are estimated to be about \$300 billion in 2006. The size of remittances has increased substantially from just slightly more than 0.5 per cent of emerging countries' GDP in the 1980s to almost 1.5 per cent now. In the 1980s remittances were the largest form of financial transfer while over the last several years remittances have been second only to FDI inflows; currently they are twice as large as official development assistance. In dynamic terms, remittances are more like aid and unlike capital flows in that they do not create a future obligation that implies a potential outflow of foreign exchange.

Remittances have averaged almost 1.7 per cent of GDP in CES Europe and at least 2.4 per cent of GDP in the CIS-11. These percentages have remained relatively stable in CES Europe since 1999 while they have been increasing in the CIS-11; however a significant proportion of this increase is probably due to improved measurement of remittances. The size of remittances varies extensively throughout the region with remittances as a percentage of GDP being over 30 in Moldova and Tajikistan, and between 10 and 20 for Armenia, Kyrgyzstan, and Serbia, and between five and ten per cent for Bulgaria, Georgia, and Uzbekistan.

## EXPORTS

Exports are by far the largest source of foreign exchange for most emerging economies, including those in the UNECE region. However exports, unlike the other financial flows already discussed, require the economy to give up real resources in order to get the foreign exchange to purchase imports. Thus although the value of exports is large, their importance is less, in terms of transferring real resources to the emerging economies. Nevertheless exports are important because the resources used to produce a dollar's worth of exports are valued less than the resources obtained from importing a dollar of imports; that in essence is the fundamental logic supporting trade liberalization. The exports of the UNECE emerging markets have grown substantially over the last several years due to rapid economic growth in their major export markets, improvements in their terms of trade (especially for the natural resource exporters), an improved pan-European infrastructure of roads and rail, progress in implementing regional trade agreements, and the reduction in other trade barriers and other transaction costs associated with trade. Exports have increased by an average of almost 25 per cent a year (2002 to 2006) for CES Europe and 29 per cent for the CIS. Export growth has been solid for all of CES Europe while the variance has been much greater in the CIS; exports have grown the fastest for Azerbaijan at over 54 per cent per year while they have grown the slowest in Armenia, Kyrgyzstan and Moldova; interestingly, these are three of only four members of the World Trade Organization (WTO) in the CIS. As a result of this rapid growth of exports, the ratio of exports to GDP has been on an upward trend for most of the economies in the region.



There are five basic ongoing trade initiatives that can possibly further increase the exports of the region. These include: (1) WTO accession for the non-members, (2) completion of the Doha Trade Round, (3) implementation of the Trade for Aid initiative, (4) further development of regional preferential trade arrangements, and (5) further reduction of transport and border impediments to trade.

## CONCLUSION

The emerging markets of the UNECE face many of the same challenges facing similar economies in the rest of the world in obtaining more resources for development. The economies in Central, East and South-East Europe along with the non-energy exporters of the CIS have, however, relied much more extensively on obtaining these resources from abroad than have countries in other parts of the world. This has allowed these economies to achieve investment rates much higher than would have been possible otherwise. This outcome is what was largely envisioned at the United Nations conference on Financing for Development held in Monterrey in 2002. Although there are significant advantages to following this development model, it also exposes these economies to a number of potential vulnerabilities which those that have relied more on internal resources do not face. For some of the UNECE economies more prudence in dealing with these vulnerabilities is probably warranted. In addition, it may be the case that several of the CES economies have over relied on external resources and will have to rely more on domestic resources especially in the light of the less favourable global environment that has recently developed. Historically in earlier decades a number of other countries relied quite heavily on external resources to finance their development, and these episodes often ended poorly with some form of debt or other financial crisis. In addition, many of the most successful economies over the last several decades, including those of east Asia, used a different economic model which was based upon export growth from undervalued exchange rates; this resulted in trade surpluses instead of the trade deficits that have characterized CES Europe. Only time will tell if the UNECE region has finally figured out how to properly develop economically using external resources or if they have simply repeated the mistakes of the past. If the former turns out to be true, then the policymakers in the UNECE emerging markets will have made a very important contribution to world economic development; however it would still need to be determined if this success could be duplicated elsewhere or if it was the result of highly specific characteristics of the region.